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**TRANSCRIPT
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PRODUCTIVITY COMMISSION

**INQUIRY INTO REGULATION OF DIRECTOR AND EXECUTIVE
REMUNERATION IN AUSTRALIA**

**MR G. BANKS, Chairman
MR R. FITZGERALD, Commissioner
PROF A. FELS, Associate Commissioner**

TRANSCRIPT OF PROCEEDINGS

AT MELBOURNE ON TUESDAY, 27 OCTOBER 2009, AT 2.03 PM

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MR BANKS: Good afternoon, ladies and gentlemen. Welcome to the first day of public hearings for the commission to receive feedback on its discussion draft for the national inquiry into executive and director remuneration in Australia. My name is Gary Banks. I'm chairman and presiding in the inquiry. On my left is Robert Fitzgerald, who is a full-time commissioner of the Productivity Commission. On my right is Alan Fels, who's been appointed as a part-time associate commissioner specific to this inquiry.

As you'd be aware, the inquiry commenced in March when we received terms of reference from the government. Since then, we've conducted very wide-ranging consultations and heard a first round of public hearings in the lead-up to releasing our discussion draft at the end of September. As you also would be aware, the draft has received a lot of publicity and has engendered considerable debate. Some of the recommendations, such as the proposed two strikes' rule, have received more attention than others and indeed the majority seem to have received broad support. But in all cases, we have welcomed feedback and I emphasise that this is only a draft and the commission is open to making changes where we think that's appropriate in light of the feedback we receive and the further research that we do.

So we encourage those with views about our recommendations and their likely effects to place their views on the public record through submissions which will then be available for wider public scrutiny and that's the important part of the Productivity Commission's process. Indeed, it's the purpose of these public hearings to give participants an opportunity to do just that and an opportunity for us to have discussion with them about their submission. This will help the commission identify the key issues warranting further thought and the various considerations that we need to take into account.

After these hearings today in Melbourne, we'll be holding a further round of hearings in Sydney, commencing on Monday, 9 November. We will then proceed to do any further work needed to refine our analysis and come up with bottom lines in our final report to government by 19 December.

I would remind participants that while the hearings are conducted as informally as possible, a transcript is made to provide a public record of discussions. There is no formal oath taking, but the Productivity Commission Act does require participants to be truthful in their remarks. Transcripts of the hearings and the submissions themselves are public documents and can be obtained from the commission's web site. Copies can also be purchased and order forms are available from staff here today or by contacting the commission.

I should add for the record that participants need not feel constrained to making a single submission. For example, participants may wish to make submissions in

response to the submissions of others and we will continue to accept submissions after these public hearings, though with a deadline of mid-November.

To comply with the requirements of the Commonwealth occupational health and safety legislation, I need to advise you that in the unlikely event of an emergency requiring evacuation of the building, exits are located in that direction and staff will be here to assist you if necessary and indeed on any other matter.

With those formalities out of the way, I'd like to welcome the first participants in this round of public hearings on the discussion draft, the Australian Human Resources Institute or AHRI. Welcome to the hearings, and could I ask you please to give your names and your positions.

MR WILSON (AHRI): Thank you, Mr Chairman. My name is Peter Wilson and I'm the national president of the Australian Human Resources Institute.

MR BANKS: I'm Paul Begley. I'm the national manager, government and media relations of the Human Resources Institute.

MR BANKS: Good. Thank you very much for being the first participants and for providing a further submission. This is your third submission, I think, and in a timely way, so we've had enough time to look at it, so we do appreciate the contribution you've made to the inquiry thus far and look forward to hearing some further feedback from you.

MR WILSON (AHRI): Thank you, Mr Chairman. Perhaps then, given that you have read our submission, I will try and focus on the essence, but perhaps I would like to make four opening comments. First of all, I would like to commend you, the commission, all the commissioners and staff for a very high quality, excellent report. I think it's done a lot to give a robust basis for public debate and discussion. We certainly appreciated the way you treated the ideas and suggestions we made. It's been handled very professionally and thoroughly and I think we're quite confident that a positive outcome will come out of this process.

I think two other comments that I would make: having had consultation with members of the profession on what we call the HR content of the report which is how it would affect my colleagues in the profession doing their work, preparing analysis and reports for boards, preparing remuneration boards in draft. There's very strong support for those elements of the recommendations. My profession does note the controversial elements in the draft report really relate to broader governance issues and more an issue for directors than they are for professions, so with that distinction, I would certainly like to characterise my profession as being very strongly supportive of the HR content.

From the institute's perspective, having regard to all of the inputs that we've had, we certainly take a position, agreeing with the principles of your report and we think there are some opportunities for those principles to be extended and perhaps for some of the practices to be enhanced or slightly varied and we see that in four areas and I'd just like to cover those briefly, if I may.

MR BANKS: Please.

MR WILSON (AHRI): The first one is your draft recommendation 1 about shareholders setting the maximum number of directors. We think diversity is a very important issue and there was an invitation in that recommendation to contribute other thoughts on diversity and we see diversity as a major source of innovation, strength and resilience in the natural sciences as it also is in business and we think that diversity could be developed perhaps as a stronger theme. We make some suggestions on the third page of our submission that a number of corporations are taking a lead on sustainability and diversity by - for example, Westpac applying for and seeking accreditation to the Dow Jones sustainability index of an all-round triple bottom line performance, including diversity, so the more companies that did that in Australia, I think the better off we would be.

We see that whilst ending the no-vacancy rule and the two strikes' policy would add some level of contestability in the market for directors, we think more needs to be done in terms of developing a shadow market at the very least or a grey market for men and women aspiring to board leadership positions, because from focus groups we've undertaken, unless you know someone very critical in a position of power, there's really nowhere to go if you're aspiring to get to the top boards and we think institutional and retail shareholders should take more interest in this and be encouraging and developing people to pursue non-executive directorships.

In the discussion there's been in terms of a director's tenure, I think good points are made that in very large and complex organisations, it takes foundation directors a few years to get to grips with the nature of the job, but we note significant evidence that a number of directors seem to stay on board for, in our view, far too long, and their ability to do that makes you - and I think the commission has focused on this - go rightly to what are the drivers of this market, and much of it comes down to governance and how the directors are elected and the whole selection process.

So we think that in the field of ending the no-vacancy rule and the two strikes' policy, there should be a further variation to the Corporations Law, developing the concept of a contestable board seat, whereby at the end of a second term in office or, say, after five years, there would be encouraged competition for the incumbent in that seat, were they to be seeking re-election. We think at the moment nomination on

committees and boards from my experience don't do a lot of work and I think one of the signs of that is that in the committee fee structure for boards, the nomination committee don't get paid a fee. They get paid a fee for the audit committee, they get paid a fee for the remuneration committee. They don't get paid a fee for the nomination committee. From my experience, it works fairly casually, irregularly, and I think in terms of value for it and effort, it's appropriate that it doesn't get paid a fee, but I think it should.

I think one of the roles of a board should be to sponsor for longer-serving directors some candidates. In our submission we recommend three, including a board-recommended candidate that would be put up to shareholders. Having said that, it makes us think: how do you make the market honest and contestable, and I think having an additional right for shareholders, very simply, a group of a hundred shareholders or those comprising at least 1 per cent of share capital, should have the right to put up separate candidates in a simple election that most corporate registries could organise for shareholders. That way, I think you would get some contesting of positions at a point where directors who have served a reasonable period are able to show their measure of contribution to the organisation, but it shouldn't be taken for granted that they continue to be re-elected until, in the case of a recent bank, 17 years in office.

PROF FELS: Can I ask you a couple of questions. First of all, almost prior to that, on this question of diversity of boards and so on, and former CEOs and senior executives are a major area from which you draw members of the board, just as a general comment, I wonder what you think about this: former executives are probably particularly good on one aspect of the role of a board, that is, steering it to making good decisions. Now, on the other aspect of a board, there's more reservation, and the other aspect of the board is to manage the principal agent problem well, to make sure that shareholder interests are looked after.

If a board is stacked with former CEOs, they're probably not likely to see the world that way, from the shareholder point of view, and often have bias towards looking after management. That would be their whole mind-set and the whole thing they have done all their life. So I just wonder about this question of a drain on executives. Maybe I'll make that point, and then I have another point to make altogether that's different.

MR WILSON (AHRI): Yes, I think that's right. Diversity, it shouldn't just come from a large stock of ex-CEOs. I don't think it does. I think even on your analysis about a third comes from senior executive ranks, most of whom have been a CEO, so two-thirds don't. You see a mixture of law, accounting, banking and the like, but there is a bias for boards who know top executives are coming through - yes, I mean, there's a knowledge factor there which, given the current selection process for

boards, makes that group of people, whether it's the top 10 or so in the 20 or 30 large companies, they get to be very well known amongst other boards and directors. The current process encourages them to be drawn on first and I don't think that's necessarily a good thing, given your distinction, which is correct, the principal agent - - -

PROF FELS: Yes.

MR BANKS: Just staying with this theme, you made the point that you think after five years, you'd want to see this contestable arrangement brought into play. Why have you chosen five years? Some would say to us that perhaps a director is only really starting to hit his or her straps after five years, so what's the balance between I guess experience, which comes with being a number of years in the job, and you obviously have some competing concerns that come with duration.

MR WILSON (AHRI): Yes, just thinking of the pragmatics of it, a number of directors tend to be elected for three-year terms, so I said two terms or a fifth year or after their fifth anniversary. If you leave it till three terms, that's nine years, and there are some countries that have a maximum or an indicative guide of 10 years. On boards in Victoria, the big water authorities, it's five years; two terms, five years, and there has to be a very strong reason to extend. Now, they're billion-dollar corporations admittedly with monopoly licence franchises, but I think it's a reasonable argument that it's a good time to contribute, to show yourself and show your stuff, and I'm not saying they shouldn't be re-elected, but I think shareholders should have a choice.

PROF FELS: Some would say there are similar issues with the appointments and reappointments of commissioners to government bodies and so on.

MR WILSON (AHRI): I wouldn't want to go down that track.

MR BANKS: They remain entirely young, enthusiastic and independent. The shadow market that you talked about, do you want to just talk a little bit more about that, particularly in relation to how shareholders would foster that.

MR WILSON (AHRI): Yes. I think particularly with the contestable board seats, there becomes an incentive to do that by itself. Let's look at two broad groups of shareholders, institutional shareholders of very large organisations and retailers, small superannuation funds. The institutional shareholders tend to have the majority and I understand that that thinking was behind and rightly behind your logic on the two 25 per cent strike points. But at the moment, they don't have a strong incentive to invest their time in governance and recontesting directors. I think they should and we said in our earlier submission to the commission that they should do it. Your

two strikes' rule and the no vacancy made me think of the logic you're applying, namely, there needs to be some test, some spur to make them think that because to say that they should think that now when, for a hundred years, they haven't, what's going to make the change? I think they should in their own interests but I'm not them and they haven't already, so what else might encourage them to do that? So our there suggestions are really part of the package.

PROF FELS: Could I just go back to another point and almost re-express what you were saying, but I was going to slightly pedantically - and I apologise - re-express in the very fashionable language of the moment. Your proposals involve slightly imparting a nudge, as is the fashionable notion at the moment, in regulation. Governments don't regulate but they nudge, and they set up certain situations which are likely to create possibilities for change but don't force it. Another term that is often used in this regard is that the governments have a role in determining the architecture of choice. They don't force a choice but they sort of influence - you know, they create choice possibilities. They may even set up the architecture of choice so that it is biased towards producing a certain result without producing it. I only mention this because it's the current fashionable language in talking about regulation and everything.

MR WILSON (AHRI): If I could extend that a little, I think in terms of your principal agent distinction, in terms of the management imperative, an experienced set of hands, that's fine. The principal agent perspective, it raises the question, if you see that's important, and we do, how do you maintain the edge, the currency of that? How do you maintain the health and the spark in that? When does it become long and lazy? That's the problem. So I think that's where the nudge needs to apply, to ensure that's adequate, appropriate and refreshed at appropriate intervals, because we can't all go on forever and at the moment, one particular group in society has an ability to do that.

MR BANKS: Just again to clarify, contestability has two dimensions to it; one is that the board would need to put forward more than one candidate.

MR WILSON (AHRI): Yes.

MR BANKS: So three candidates, two in addition to the one who's being renewed and they would have freedom to choose who those other two will be.

MR WILSON (AHRI): Yes.

MR BANKS: Then the shareholders would also have - there would be some extra provision enabling them to do that.

MR WILSON (AHRI): Yes. Can I comment on that?

MR BANKS: Yes.

MR WILSON (AHRI): I chose three for two reasons. 30 per cent of women are getting through to major leadership positions in our parliament and we'll probably see 30 per cent of women in the cabinets, shadow and current, so I think from what I've seen in executive potential assessments of men and women, I think providing for about a 30 per cent leadership factor would be appropriate. So allowing for three candidates from the board enables at least one to have diversity attributes. Now, I didn't say that was mandatory but I think that would be good for boards to sponsor.

You spoke of the Lake Wobegon effect. The other dilemma that I would mention for the record from the Yes, Minister TV series is the Bishop of Bury St Edmonds, where the church had to sponsor to the Prime Minister two people to be appointed bishop in the 80s and the Prime Minister was bemused about that, and when he was briefed on it, he said, "Well, you've got two candidates but one isn't meant to succeed." You know, you've got the one that they want you to pick, and when you look at this other person, he isn't going to go anywhere, and he doesn't believe in God.

MR BANKS: A slight handicap.

MR WILSON (AHRI): So I think the difficulty in asking a board to put up three candidates is that you want them to put up their best three candidates. How do you provide the nudge for that? Basically you have a right for shareholders to come in with their own candidates, so the board will actually put up, you would hope, the three best from some fairly thorough search process that they have undertaken, so that if their top person who happened to be controversial for whatever reason got knocked off, there's a good chance that their candidates 2 or 3 would get up. How do you optimise the likelihood of that? You give people a chance to put up some others.

MR BANKS: Just coming back to your earlier point about nomination committee members not being paid for their task, and there's an old saying about peanuts or something, but obviously your implication is that maybe it's not seen as demanding an activity as some others and that could be because it's a more infrequent one, although there is a question as to whether they could be continuously thinking about having a reserve of good candidates and so on. So around the remuneration committees, the nomination committee - maybe I'm jumping the gun here a little bit - but is there more work that we can sort of require them to do and would it be right that in fact they may not be canvassing as many potential applicants for director positions as they should be?

MR WILSON (AHRI): My experience is they're not. I've worked in two companies and I have colleagues that have supported a range of others. It's difficult to deduce completely because they're usually private minutes of the board but I have seen them to occur, you know, after lunch, for 10 or 15 minutes. Unlike audit or remuneration or HR, where there's a long-term program, they tend to be formed informally, and basically the psyche of the board is, "We would like to have an optimal structure," six, seven, eight or nine people, and the pressure comes when it's really somebody not performing, which might come out of the board review, or someone is coming up to retirement and they say, "I want to go," so that the consideration comes "replacement". That's the first thought. It seems a very informal process. Search firms would have you believe they are heavily involved in a lot of them. I've not seen that. It's basically the directors caucusing, sometimes asking the CEO but usually by themselves and there's a bit of ringing around, a bit of shoulder tapping. They select and interview a candidate and then the chairman goes around and visits the large institution shareholders, they're elected before an AGM, then put up and confirmed at the next AGM and then on it goes. It's not really what you would call a highly contestable competitive process, despite the very good intent, I'm sure, that many directors have in pursuing it, but that is what I've seen to be the process and I think that's questionable when you're looking at billion-dollar corporations, the stewardship and the principal agent problem.

MR BANKS: Just taking that a bit further, you would see it as considerably less contestable than the appointment of a CEO, for example?

MR WILSON (AHRI): Absolutely, yes. I mean, there you've got a search firm. I've seen four global searches for CEOs in banking and manufacturing. Those search firms work very hard. They do a long list sometimes of 30 candidates. They rank them, they stratify them according to their performance and potential and then you get the board interviewing, say, the top six or so two or three times. There are more tests. It's a very rigorous process.

I think you will see we have supported a lot of recommendations. I won't spend time on this. What I liked about recommendations 2 to 7, I would like to say for the record, is that you've strongly gripped onto the principle that when a right is conferred, it should be exercised responsibly and transparently or if there's a material conflict of interest, it should be waived. I think that principle is behind a lot of your recommendations which both my profession and I strongly support.

One comment on draft recommendations 8 and 9, in terms of what goes in the remuneration report, is I think at the moment there's a lot of hunting that goes on across tables and I think having a simple table, given your focus on the CEO and key management personnel, one table or one point where it all comes together, I know

from talking to some shareholders they get a bit confused and often long-term incentive detail is sort off into the pages and it never comes back. So I think saying there should be one place where shareholders can find the total remuneration by parts with some clear statements of value would be healthy.

The third thing we would like to cover is your draft finding 1 and as I say in our submission, there were two reasons why we proposed a remuneration code, (1) for best practice and (2) for governance. We completely accept the analysis you say as to why it would not be good for governance for some form of compliance and we agree with you that it's best to allow more time for non-binding remuneration reports to work - they clearly are getting better - and also to focus on the other areas where you've recommended approval.

However, we still see a residual value in the best-practice notion and you yourselves had a check list and we've suggested that too. We think that having best-practice guidelines on remuneration, some sort of a stamp for that would be valuable, and when you look at the list of what other best-practice standards we have, I mean, there are issues about impact on the public in terms of quality of products, quality of safety systems, the impact on the environment, and whilst remuneration is a softer subject, I think there's sufficient interest and continued interest in it that the more we can raise a sharp set of best-practice guidelines somewhere, that would be better, and if it could get to the Australian standard in status, then you would find a lot of the mid-range listed companies would find it of value; I know 14000 on environment; 4801, occupational health and safety. The big guys look after themselves very nicely. They have got enormous resources, very capable people. They follow these and they try and go in a little bit further. But I think for ASX-100 onwards, you get different degrees of finesse and skill in putting remuneration together and having a template somewhere I think would help that.

MR FITZGERALD: Can I ask a question. Is it the institution's intent to actually develop that code, irrespective of our recommendations? In one of your previous submissions you've indicated a template for that particular code, so is the institute itself going to invest in developing one, irrespective of our recommendations?

MR WILSON (AHRI): We haven't taken that decision but as you've asked the question, I think the answer would be yes. I would hope that if one was to be developed - and it wouldn't stop us developing it on a collegiate basis - I would probably go to the company directors and others that I think would have value to add, but I think it would be more powerful if it was sponsored as a collegiate best practice piece of work, particularly if it went somewhere into the standards process. That would be more valuable to society than if AHRI did it by itself. If that's the least we have, then that's what we would probably do.

MR FITZGERALD: Okay, yes.

MR WILSON (AHRI): In terms of your check list though, we have two variations to recommend; one was the reference at the third dot point where we add in the words "and how such benchmarks have been applied". There are some reasons for that. I think your own positing and testing of the Lake Wobegon effect is somewhat inconclusive. We don't actually know. I think in a remuneration report, if a board was to say, "We are paying our CEO at the third quartile for the ASX All Industrials excluding resources and financial," which is a common benchmark for those outside resources, "and we're paying him at the third quartile," and then if you find after all ASX 100 reports have been tabled that all boards are paying their CEOs at the third quartile, we know what's going to happen. At the moment, we don't know. Even with the key management personnel, if you had some simple metric of the percentile positioning, then you would actually have some transparency on, "Is the dial being moved up year after year?" and therefore the averages will next year, or is it more concentrated around the mean. At the moment we don't know. The criticisms of that have been, "We can't say too much about our executives and market benchmarks because that's competitive information," but having some simple percentile metric or average metric does give you a sense of the board's philosophy on pay. It's not a publicly contested market. It's not like the ASX where you can trot down and see what BHP's share price is, this is a privately managed market and so how people set values in that market and the spread of that is important information. At the moment, I think on the draft report, we would see better remuneration reports but not necessarily the rationale or the point estimates for the market benchmarking which I think would be a useful piece of information to capture.

The second suggestion we had is the issue of, particularly for incentive pay, how deferral principles are applied and forfeiture conditions work. Again, unclear evidence to date but I think a public concern is: are incentive payments generally at risk when things go down? So I think asking for some statement of principle on forfeiture of bonus or total forfeiture of any outstanding incentive wouldn't take a lot. I mean, in my experience you find once the principles are set for the CEO and the senior team, they pretty much flow through the organisation, with a bit of fine-tuning for people like treasury managers and foreign exchange jockeys and the like. But by and large, the tone at the top does flow through the organisation generally.

The last point I would like to comment on and I'm sure it won't be the last comment you hear on the point is the two strikes' principle. We do agree in principle with the principles of the two strikes and initially I thought the two 25 per cents were appropriate. The public debate caused me to think about that again and basically I think the first strike which is, if you like, what's an appropriate level of concern for shareholders to register that they don't like what they see in the remuneration report and I think your argument about giving the smaller shareholders, who to date have

been relatively disadvantaged, a say, does augur for a lower strike point there. Once you have that, then you've triggered the explanation strike that needs to occur in a year's time. Thinking of the consequences of that vote and beyond that makes you think what is the second percentage appropriately structured as, some of the criticisms being, "This will spill the board, cause great uncertainty, expose us to takeover," and the like. Some of that I've seen as fairly self-serving, to be honest, but I think it is true if the second strike is invoked, whatever the percentage is, the board has to be elected. The board has to offer itself for re-election.

Now, if you've had two 25 per cent points and the negative vote is just a bit above that in the second strike, then it's highly likely, unless there's massive changes to shareholding, that the board will be re-elected on a 51 per cent vote. So you are triggering towards a lot of uncertainty over that year which could get caught up with takeovers and other issues; I do accept that. So I think the second strike point should be higher. Having given the retail shareholders an opportunity to voice their dissent and go to the second strike, the onus then is on the boards to really get the explanation right and if they don't get it, then I think you move to the third strike on the basis that the dissent to the explanatory point or the dissent around the explanation is so high, it's almost certain that this board should substantially change or move on and that is a number much closer to 50 per cent, and we've said in our submission 45 per cent for the sake of argument but it could go as high as 50. That I think would take a lot of the sting out of the criticism because basically if you're getting a second strike closer to 50 per cent, then any board and the public will see, "Well, this board really has to consider whether it should be there at all." If it's a bit over 25 per cent, I think it's less certain.

MR BANKS: Maybe we could just pause. Were you going to go on and elaborate on those - - -

MR WILSON (AHRI): Just on the last couple of points, about the AGM and the EGM. That's what I was wanting to say on - - -

MR BANKS: Just before we get to that, could you comment - I mean, I think implicit in what you're saying is that if the threshold was low, you would have a spill for no purpose. Others might argue it does have a purpose, in the sense that boards will want to avoid such a thing happening, probably on personal grounds as well as potential disruption to the company. But do you have any views to offer about how disruptive it would be to have the whole board presenting itself for re-election?

MR WILSON (AHRI): I don't think much as been made out - just to jump ahead to our recommendation, I think the managing director or any other executive director should be excluded from that because they generally have a contract of employment and I think you've rightly said they shouldn't have anything to do with assessing their

own remuneration, so they really don't have a role to account to shareholders.

MR BANKS: I probably should say on the record that we hadn't envisaged that they would be, so I think we take the points you make there.

MR WILSON (AHRI): Okay. So assuming that it's an issue for the other non-executive directors - and on most boards, there's only one executive director which is the MD, so let's presume it's the rest of the board less one - it raises the issue: what does the board actually do? Principal agent accountability; it's the steward for governance. I mean, the board's job very simply is well summarised in the literature as to hire and fire the CEO, to endorse strategy and to oversee governance. So the issue would be: is something likely to happen that would significantly destabilise the governance process or the condition of the company? Now, someone might take a poke at it in terms of a takeover but then again, usually after takeovers, the board goes anyway, so the board is in an uncertain condition if it's subject to a takeover. Some would say this would actually encourage that to happen. At the margin, I hear the argument but I don't feel the magnitude of it. I think particularly if you inoculate the managing director from that spill, then the company is going to continue to be managed. We're not actually saying that the board isn't going to be there tomorrow, they're going to continue right through to the third strike point, the third AGM. I've seen boards where a couple of directors have retired and they're working just as hard all the way through to the end of their term. They're not suddenly leaning on their shovel and thinking, "Well, I'm losing interest." They just aren't those sort of people; they're generally hardworking, very productive and they would probably be looking for leaving the organisation in good shape and leaving. So there is some issue around - it does put a termination point for them and there's some slight hazards of that but I don't think they're very large, particularly at the second strike point as high.

PROF FELS: The elections are for each individual member of the board.

MR WILSON (AHRI): Yes.

PROF FELS: It wouldn't be "chuck the board out", it would be, "You vote on this, this, this and this person."

MR WILSON (AHRI): Yes, I accept that. Shareholders may have greater or less transparency on the individual accountability. Certainly they would look at the chair of the remuneration committee and other members perhaps more strongly.

PROF FELS: Yes.

MR WILSON (AHRI): But beyond that distinction they're really judging it on

public information.

MR WILSON (AHRI): Under current arrangements, shareholders with 5 per cent could nevertheless achieve the same thing if they wanted to, so do you have any comment to make about why the two strikes' approach would be more problematic than what already exists as an opportunity, even with a lower threshold?

MR WILSON (AHRI): No. I don't feel strongly moved on that. I don't feel the two strikes provides a greater issue of uncertainty there than the 5 per cent but what's happening - I mean, this isn't the Exxon Valdesse where we've had a giant oil spill. The big issue at the moment is - well, the environment is very important but people are very concerned about remuneration and so you're providing a strike point against a particular issue or a particular element of governance, but that is because people feel very concerned about what has happened. If we are accelerating into a recovery, then you are going to get excess demand issues and remuneration and the opportunity for some lax standards amongst boards. So I think the issue isn't going to go away just because we've recognised it and the GFC caused all those massive losses; it's going to continue. It's an ongoing part of managing a company which the public are going to maintain a high interest in.

PROF FELS: We're hearing lots of stories about behavioural changes; whenever you want to make a change to the law or regulations, people come up with stories and often they're kind of an incomplete analysis of all the behavioural changes and they tend to pick one or two which may suit their argument. Just going to the most fundamental one, if the two strikes' rule were adopted and if it really were likely to have some kind of effect - and I know a lot of people say this is just not going to have any effect whatsoever - but if it were somewhat credible, I suppose the first response to it would be that boards would exercise even more care than at present regarding remuneration. I imagine that would be the first behavioural change, wouldn't it?

MR WILSON (AHRI): I would think so yes.

PROF FELS: For better or worse, possibly for better.

MR WILSON (AHRI): Possibly. You will hear the words "become uncompetitive", "not attract the right people", all that stuff.

PROF FELS: They might get voted out for that.

MR WILSON (AHRI): Not much risk at the moment.

MR BANKS: Would this kind of signalling effect of the two strikes be - how

muted would that be by what you're suggesting, moving from 25 to say 45 per cent as the trigger?

MR WILSON (AHRI): I think it should significantly mute it because the prospect of going to the third strike is now less. It's really for the extreme cases where the board, having 12 months to explain their actions and put up an answer, hasn't convinced nearly the majority of shareholders. That's a different situation to now, where a quarter of them remain unhappy and you still go on to the third strike.

PROF FELS: I suppose it could be argued that they're getting a pretty good deal and then if you make a mistake in business, you tend to get fired. Now, our boards are probably going to have two meetings and then after that, there will be a vote. The process could go for three years or maybe two and a half. Is that a very tough regime?

MR WILSON (AHRI): No.

PROF FELS: It's tougher in universities and in government than that.

MR WILSON (AHRI): I do have a management perspective on that and I see it as being much tougher in senior management than it is on a board. There's a whole host of reasons why you can suddenly be told you no longer have a job.

MR BANKS: The other issue that people have raised is I suppose the reach of this proposal, covering the whole board, and people have suggested that apart from executive directors, you wouldn't include someone who wasn't implicated at the remuneration report who might have come on to the board very recently or something like that. Others have said, getting back to this notion that a spill could be disruptive, it would be better to target the chair of the remuneration committee or indeed the chair of the board or indeed the two chairs, do you have any views about that kind of more targeted approach in relation to the coverage of the two strikes?

MR WILSON (AHRI): I do. I can see moral hazards in both options effectively, just to separate the remuneration committee and the board, but I actually am strongly persuaded by - that the focus should be the joint and several responsibility of board members; that even though there is a remuneration committee, the board should have the incentive to both invest time in what they're doing and how they're doing it and the results of it, just in the same way that an audit committee does when it reports to the full board. If you sever that connection and just focus on either the chair of the remuneration committee or the remuneration committee, I think you're weakening the board structure and opening up a bigger hazard than if it's collegiate 100 per cent.

PROF FELS: Could I just ask a question. I imagine that if you're voting for each

member of the board you have an opportunity of discriminating between them if you wanted to, if you're a shareholder.

MR WILSON (AHRI): Absolutely, and that's what I understood your proposal was allowing, it isn't a job loss, it's individual elections.

MR FITZGERALD: Just a broader question, moving away from the two strikes, in a couple of the presentations that I've given, people have raised questions that they believe that somehow or another our report diminishes the role of the human resource professionals within the organisations and in part I think that's because of our requirement that remuneration consultants, if used, would be appointed by the board and reported to the board. I must say that we don't see it in that way and I have tried to explain why that's the case. But I was just wondering whether or not there's anything in our recommendations or the report generally that would in fact cause people to believe that the human resource professionals have been lessened in their role in this particular approach.

MR WILSON (AHRI): No, the particular instance you raise certainly has been discussed, the people that I have consulted with and what they have basically said is that we would need to have - they can't do their work unless they have access to the market benchmarks. So it would mean either it's contracted by the board and the board gives permission for certain information flows to management to enable them to do their job or he may well find management seeking separate remuneration consulting advice. So it's very good for the consultants in the sense that management might need to have direct advice to inform itself on what's happening in the market. In my experience the results don't vary very much, you tend to get very similar benchmarks. But nowhere have I hear anyone say it diminishes the profession.

What I have heard said is that this is good, really good. It's simple, it's clear it's how we should be going, we should be getting on with it. No-one eschews the word diminish or demean or change it and I think there has been a recognition in that recommendation and others that the ultimate arbiter in this is the board. The board has the right to seek its own advice and it should contract to that and it should be telegraphing that to shareholders, we accept that. There may need to be some supporting mechanisms around that to enable HR to do its job, but they don't feel it's a zero-sum game, they've been disadvantaged at the expense of the board and its thinking, no.

MR FITZGERALD: Can I just go back to the code which I raised earlier. You've mentioned here the ISO route which is quite possible. If you were to establish an ISO standard around remuneration packaging, to what extent do you think boards would in fact use it? It's a non-binding approach, it's there as a guidance, I presume. I was just looking at your list, you've got the environment and quality and so on and

so forth. If one were to recommend that there be a standard developed in this way, I presume it would be a non-binding standard.

MR WILSON (AHRI): Yes.

MR FITZGERALD: Do you actually think that the time and effort and the energy in developing that would be worth it in the sense of do you have confidence that the corporate sector will actually use it?

MR WILSON (AHRI): Yes, I do. In putting the draft remuneration code together in our second submission I consulted with HR heads of very large companies and the view was, apart from some of the controversial elements around compliance. "Peter, this is what we do anyway," and in your submission you have the check list that we gave. That's what we do anyway and that's where I got the idea because I was one of them a few years ago and it hasn't changed that much. The efficiency loss I think you have is in the medium to smaller list of companies who don't have the expertise on their boards, perhaps have more of an all-rounder HR person because you find remuneration and HR people are quite specialist, particularly around the algorithms of long-term incentives and the like and they, I think, as a subgroup, which is a very large subgroup, are looking for help.

So I think we tend to think of this as, "What does it mean for the really big companies?" and it wouldn't do very much for them, I agree with that. But I think at ASX-100 onwards down towards 2000 to the extent that they have to improve their remuneration reporting, they would very much benefit, not only from your check list, but I think taking that concept further as these other instances I've given are what they use. They need some sort of ready reckoner, I think, and the more complex we have seen remuneration get, the stronger that demand is and it's not there at the moment.

MR FITZGERALD: Thank you.

MR BANKS: Another way at that, I suppose, is what you're saying is the existing guidelines that we document in the report, OCD and others, you don't think do the job adequately.

MR WILSON (AHRI): No.

MR BANKS: Okay.

MR WILSON (AHRI): I think my closing comments, Mr Chairman, on the AGM/EGM question you posed, I would retain the option rather than make the choice. If, for example, the board is in a steady state situation, they feel that nothing

is much going to happen and they'd like to take the third before they come up to re-election for whatever good news they may have in store or whatever, they should have that. If they really feel the air is foul and it needs to be cleansed very quickly, then there should be the right to go to an EGM if they feel in the board's company's and the shareholder' interests we need to get rid of this very quickly. So I wouldn't make the choice, I would allow the option - AGM, unless the board wants to elect for an EGM to have it determined it quickly.

PROF FELS: Wouldn't you want to make it be a statute - well, all right, so you leave the statute open, I suppose. It just sounds funny. I mean, imagine there's 90 per cent out against the wall, totally incalculable though that would be, then it should be up to the board to determine how long it hangs around?

MR WILSON (AHRI): You've got your other 5 per cent rule. If you have a 90 per cent vote against you, then probably 5 per cent of the shareholders will say, "We need to have EGM."

PROF FELS: That's interesting, the interaction of the 5 per cent rule is a very interesting situation.

MR WILSON (AHRI): Yes. I think my last point was which you conceded, to basically cleanse the managing direction out of any spill. So that was really all we wanted to raise, Mr Chairman. Again, thanks from myself and my institute for the very thorough, professional job you've done and it's been a pleasure to be part of this process. I wish you well in the move towards the final report.

MR BANKS: Thank you and thank you again for your substantial contribution. We will just break now for afternoon tea.

MR BANKS: Our next participant this afternoon is Norm West. Welcome to the hearings. Maybe just reaffirm your name and the capacity in which you're here today, please.

MR WEST: Thank you very much. Norm West, and I live in Bendigo. I am a retail shareholder, have been for a long time. I have shares in my own name and in a self-managed superannuation fund. I am a member of the Australian Shareholders Association and a company monitor, but I am here as a private individual.

MR BANKS: Good, thank you. We appreciate you taking the trouble to appear and you have come a reasonable distance, I think. We will give you the opportunity to run through the main points you want to make.

MR WEST: Thank you. Basically because of a company monitoring background I was interested in the report and I got the impression as I read it that the retail shareholder wasn't highlighted, so I thought, "Well, at least I've put in a submission and a couple of points I'm rather keen about raising and they're the ones I'd like to go on with." The first one, it seems to me that the argument is took simple at present because there are excessive salaries being paid and bonuses and things like that, but that's where the argument seems to sit and it makes it a lot easier, I think, for people to defend that situation where it's just high salaries, shareholders have got no idea what the market should pay and therefore you should accept what the experts say or whatever the board says.

As I have mentioned in my submission, there are other things that annoy retail shareholders and one is this business about sensitivity of boards. If boards are terribly sensitive, if they get a very high no vote on the rem report, you would expect something would change rather dramatically. In many cases it hasn't, and I've given some examples, the Oxiana/Oz Minerals. It was rejected, it went back, it was tweaked and they got through because it didn't have to go back to a shareholder vote. That's fairly annoying and doesn't do much for the company's public image. I thought that Pacific Brands wasn't so much about the salary of the exec, it was more to do with the fact that you had a lot of people being put off at the same time that a bonus was being paid which I think offends the fair-go ethic that's still reasonably common in Australian society.

Then we have the cases there where people are given high pay for, saying, nine months' work. In other words, it's basically seen as undeserved. It may be high, but it's more the undeserving aspect of it that's causing the problem. The you get back to the obscene and excessive salaries as well. I think this sort of social background to it needs to be taken into consideration when we talk about a report like this. I just hope that when the final report comes out that some of these other aspects need to be taken into consideration.

The two recommendations that I'd really like to talk about are shareholder engagement which is very something that affects me as a small shareholder. The first one about electronic voting, no problem whatsoever, strongly support it. But there is another bit of a sleeping issue that comes up at the same time. The time we brought in this electronic voting, we've also brought in ballots and I just came out this morning from the Transurban AGM where at the start it was said, "We're going to have a ballot and we will not have any show of hands." I object to that as a shareholder. I believe that the show of hands is a great old tradition and it does allow the average shareholder to at least have their say. If I come down from Bendigo to Melbourne strop about something or other, it goes to a ballot, I can't express my displeasure, or support for that matter, it goes to a ballot and in a couple of days' time it comes up on somebody's web site or it may be reported in the press.

As I put in here, I'd like to see the show of hands retained up to chairman. It's an opportunity for the people who take the time and the trouble and the interest - and we're talking about engaging shareholders - come to the meeting and express their displeasure. It does not alter the vote. If the chairman says, "We're going to have a ballot," that's okay, "but we will have a show of hands," the show of hands is given, they say, "Okay, it's passed on the show of hands," or, "It's lost on the show of hands," we will await the total ballot. It doesn't cost a cracker, takes about a minute. I think it's something that chairmen of boards should not have the option of no show of hands. I think it should be put in there, should be recorded in the minutes, but I'm not asking that it has any effect whatsoever on the vote.

MR BANKS: Are you speaking now specifically in relation to the remuneration report?

MR WEST: No, all.

MR BANKS: Right.

MR WEST: The only reason I talk about that is that's the most controversial one and that's the one you don't get a show of hands on most times. But the reality of most company meetings is that the proxies go up and there's squillions and millions for and a few against. But that doesn't alter the fact that there are some meetings where small shareholders go along and they're very unhappy about something. It is normally the rem report. But it just seems to me it's an opportunity there for the small shareholder, individual shareholder to at least have a say. There was a company meeting a couple of years ago, very, very antagonistic. The just got chopped off and you sort of walked out with a very empty feeling actually. So I would request that that be considered as an inclusion, that it should be held for the meetings and not as an option to wipe a show of hands out.

The second point is reco 15, the so-called two strikes. I object to the two strikes, I think it's an easy way of belittling it. I am very much in favour of it as a shareholder. I think that 25 per cent initially is a very good figure. Why? We seem to have broken the companies up that some companies get 5, 10, a small protest vote and then you get the companies that get up to 40s and 50s and 25 sort of sits in the middle and I think it's a fair figure. I do endorse the 25 per cent second time round, as much as the public criticism is against it for two reasons, I think. The first one is, if you bring it in this year there's 12 months to put a report out, he's get 25 per cent against it. There's 12 months again to get it right and there's 25 per cent against it and there's some debate about whether it goes for another year. It seems to me if you can't get something right in two and a quarter years to three years, there is something the matter. To make it higher the second time round just defies logic to me. Am I allowed to quote out of a paper?

MR BANKS: Absolutely.

MR WEST: In the Fin Review at the weekend these companies that got the bad vote, what you need to look at is not the high vote this year, it's what happened from last year. Downer got a 15 against and went to 59. United had 37 against it, above the threshold. Did that have any effect? No, they went to 50. Qantas went from 42 to 44. So if a board is willing to wear the flak they get a 25 against. Current practice is showing they're not having much effect on it. If it was pushed up to 50 per cent or something like that, I could see a few boards saying, "Okay, we've just about got the proxies, we can wear it," and that's not the intent, as I see it. So for the two reasons: (1) current practice shows that some boards are strong, if you like, but more not very sensitive to shareholders, are willing to wear it so it's got to be kept reasonably low so that they keep reasonably honest; (2) I just believe the time line does give boards enough time to sort it out. I think you have to clarify whether it's 25 per cent of votes cast or 25 per cent of possible votes that could be cast. I just think that needs to be clarified before you go any further with it.

You asked the other question, what should you do after that? Personally, I'm very much of the belief you've got to have closure some time. I'd like to see an EGM in a set period of time, three months, six months. If a board gets back in and everybody knows that they get 50 per cent, if they get back they'll think that's the issues, they solved the problem and you start a new life altogether. I just don't think it can drag on and on and on. Thank you very much.

MR BANKS: Thank you. In your remarks there about what the effect of different threshold triggers would be, you said the board would say, "We've got the proxies and therefore we'll ignore it." Of course, another one of our recommendations is that boards not be permitted to vote undirected proxies.

MR WEST: An excellent move.

MR BANKS: Do you think that would tighten the leverage on an existing threshold figure?

MR WEST: No.

MR BANKS: I suppose what I mean is would it give a bit more power to the shareholders at a lower - - -

MR WEST: I think it's an excellent move. I believe it's a very, very positive one. But, as I say, I just came out of a meeting where 200 million and 12 million undirected and I don't know - you'd have to do a survey of companies to work it out. Where there's high undirected proxies it might work, but that's the crucial thing. I think it's a good move and I don't think they should be voted but I'm not too sure in some of these very controversial cases where people do direct their proxies and you're right, everybody's argument should be that everybody who is a shareholder should actually direct their proxies. They shouldn't give open proxies. That's not engaging shareholders at all. So I'm saying yes, but I don't think the practical result there would make much difference.

MR BANKS: Some have argued the contrary and they've said that it's the shareholder's right, that in a sense we're disenfranchising those shareholders who would want to provide their undirected proxies to the chair, for example, and trust the chair's judgment.

MR WEST: Again, to me, if you want to engage and educate shareholders, they should never do that, they should work it out themselves and say, "This is the way that I want it," they should do that rather than just passing them over. I don't like the concept of undirected proxies to begin with, but if they go to the chairman and he does vote them there, you are loading the dice a bit.

MR FITZGERALD: One of the things that boards have said to us, it's very difficult to actually understand what shareholders really want, that is, that the shareholder group is not a homogeneous group and with the advent of day trading and what have you, it's become even more complex. So I was just wondering what's your view as a retail shareholder as to what you want to see from a company. When they're setting remuneration arrangements, what is it that motivates to actually believe it's a good package or that in fact it's an unsatisfactory package?

MR WEST: Firstly, I'd have to say that the majority of boards that I've seen are competent people and I've got no hassle with them. It's just these few boards that are

completely insensitive to votes. But anyway, in answer to your question, I think somehow or another it's got to be linked to shareholder returns, and I'm talking as a retail shareholder. You cannot possibly, in my opinion, have the company make a loss and a bonus be paid. Let me qualify that a little bit. There may be somebody there who has got to plug the leak in the dam and is going to get a bonus if he does it. But we're talking about the general running of the company, say, the chief exec. If that company has gone down, the chief exec has got to feel a little bit of the pain the same way.

So it just does not make any sense that bonuses are connected somehow or another to company performance, albeit directly related to shareholder performance. So that could be the total shareholder return, it could be the actual earnings per share which I think is a fairly good marker and certainly the emphasis on short-term incentives, I think, has been unhealthy and I think there is a move towards longer term incentives but I'd definitely like to see a link to shareholder return, run it over a longer period, more money being paid for long-term development of the company rather than a short-term fix because the short-term fix, I think, can be every effective but more to do with the economic climate. Like, there's been a big turnaround and some of these bonuses will be paid this year, I think, because the company has suddenly improved from here up to here.

Just a more transparent linking to what the shareholder gets and, as I say, if the shareholder gets no dividend and the company makes a loss, that should be a couple of very, very good arguments there that bonuses and incentives shouldn't work and not after the event. The board's responsibility, as I see it, is to make certain when they do the deal and set it up that they will cover that. I think half our problem has been that when people get termination payments, something that worked out five years ago, it suddenly doesn't look too bright, either the share price has gone up or the options have gone up and I think board probably also need to have a look more long-term and do a few more "what ifs"; what if there's a crisis, what if something or other happens or what if we have to terminate. As I said back there, people get terminated because the company has gone bad and somehow or another they end up with a lot of bonuses and again, this does not go down very well.

MR FITZGERALD: As a retail shareholder - and you haven't raised this in your submission but I was wondering if I could ask - to what extent do you believe the current remuneration reports aid you in making those decisions or are the reports in fact so complex that they are in fact not a very good aid? Related to that, some directors have raised concerns about the role of proxy advisers or shareholder advisers of overstepping the mark and becoming too influential. So I was just wondering about this whole issue of adequate disclosure and the increasing role of external third party advisers to shareholders.

MR WEST: I think the remuneration reports have been proved dramatically because now we get information. But what has happened is they've now become so complex they're now getting back to being opaque again so the big ones probably need to be slimmed down a bit. What is generally missing is that they're going to get a bonus if they get this 50 percentile et cetera. But as a retail shareholder it would be nice to know that the company will increase the profit by 5 per cent, 10 per cent and a lot of this stuff is not published so that needs to be published. They do need to be simplified so that what you - you've got Joe Bloggs, managing director, gets X hundred thousand dollars because of the company's profit - whichever way you define it - has increased by 10 per cent over the previous year.

Just a personal little beef, there was one very recent company meeting where the managing director got a 100 per cent of his bonus when he hit the 50th percentile which to me is median, other people might call it average. When he got to the 75 percentile, he hit 150 per cent which I thought was a bit like you run in the middle of the Melbourne Cup and you get 150 per cent of the stake money, which is not bad going. So I think they need to be simplified, but in a simplified manner, "Do this, you get that," and not very many reports are that simple.

MR FITZGERALD: In relation to your issue about the show of hands, I understand why you think that might be a good demonstration effect and I can understand why, as a retail shareholder, you might feel empowered by that. But do you actually think boards care whether they lose the show of hands vote or not? I can understand the publicity that goes with it, that they immediately call, as you say, a poll or what have you and, as we've seen the other day, it's soon swamped by another set of figures. So does it actually have an effect on boards?

MR WEST: I take you back to the non-binding remuneration report. It has had an effect. So I think there are some boards who will wear it, it won't have any effect. Most boards, I think, are sensitive and most boards do listen to their shareholders and if they knew that that was on the table, they would be sensitive to it. But there is no doubt that the non-binding report has worked for a number of companies. Some of them have pulled it out, they've done their homework and others have changed. I've pointed out some that haven't changed. But, yes, I believe it has an effect. It may be bluff, like it's non-binding or anything like that but it's just another thing where little shareholders can get some sort of a say once a year. That's about all it is. I know it's not going to deliberately change them but it has some effect. The board members are normal people and I don't think they particularly want to be seen to be in a bad light. I don't know, you'd have to ask the board.

MR FITZGERALD: My last question is, in relation to the three companies that you've referred to where there's been a higher no vote on the second year round, in other words, your proposition is not only have they taken no notice, in fact they've

angered the shareholders further. When you look at that, how do you assess that? What do you think is happening at those boards, is it simply an arrogance or do you believe there is a disconnect between the board and the shareholders or what do you think is happening in those companies where they have failed to take notice of very substantial first round no votes?

MR WEST: That's the question you should put to the board because my answer would probably be "all of the above". Certainly a disconnect to shareholders. I think there's a problem with the board that gets in a position and say, "We're going to do it this way and we can wear the flak." That seems to be the impression. This is a generalisation, I know, but it seems that where those boards take that position, they are boards that aren't very sensitive to shareholder concerns in a number of other ways as well. That's my impression as going to annual general meetings. I could talk lots and lots about what a good annual general meeting which has got nothing to do with it here, but if you go to an annual general meeting - and I try to go to a few - there's an atmosphere at an annual general meeting that comes through the board, the chairman, the way it's presented. I had an argument today with one of the directors, the food went off in about five minutes and I said, "That's not very good." He said, "That's all we're putting on."

You either believe in annual general meetings, and that's a very good sign and you try and promote the company through it, and therefore if you believe in that you're going to be very sensitive to trying to come to terms with what the shareholders are saying. Bottom line, I think it is a personal attitude of the board, possibly driven there by the hierarchy of the board, I don't know. That's just my feeling of going to meetings.

MR BANKS: Thank you very much for attending today. I hope you catch your train.

MR FITZGERALD: Thanks very much.

MR WEST: Thank you.

MR BANKS: We'll just break now before our final participant today. Thank you.

MR BANKS: Our next participant is the Australian Council of Trade Unions, the ACTU. Welcome to the hearings. Could I ask you please to give your names and positions.

MR BELCHAMBER (ACTU): Grant Belchamber, economist, ACTU.

MR BANKS: Thank you.

MS GAYNOR (ACTU): Marion Gaynor, research officer, Australian Council of Trade Unions.

MR BANKS: Thank you very much. Thanks for taking the trouble to appear today and also for the earlier submission that we received. I'll hand over to you, Grant, to make the main points you want to make.

MR BELCHAMBER (ACTU): Thank you very much. It's a great pleasure to be here. The ACTU welcomed the draft report. It contains a vast amount of useful information and sheds a welcome light on some dark secrets. The basis for community concern about executive salary excess has not evaporated. Reports of excess continue to appear and the ACTU has made a number of media releases referring to these continuing reports on 1 October, there was one about Leighton Holdings, it was only a week or two before that as well. We believe the draft report can and should be toughened further, five specific points on the two strikes' proposal. We think this is a constructive proposal. The threshold at the second meeting should be 25 per cent of shareholders to spill the board. If this threshold is met, an extraordinary AGM should be called forthwith, don't wait for the next scheduled AGM a year later or the matter becomes stale.

Secondly, data adequacy. The draft report is laced liberally with observations about the inadequacy of appropriate reliable data. The inquiry terms of reference call for recommendations about the framework for governing remuneration practices and how it could be strengthened, but the draft report makes no recommendations about improving data inadequacy. The ACTU has put to this inquiry and in other fora for many years that an official series with statistical integrity can readily be compiled, for example, through the ABS May survey, the EEH survey, employee earnings and hours. That's a survey with a two-stage sample, a random sample of employers who are then required to sample their employees, to generate a sample of employees. In the second stage it would be administratively straightforward and occasion minimal additional respondent load to include a mandatory waiver of employees comprising the CEO and, say, the top five - a defined number of top paid executives.

Firms are required to disclose remuneration already. The data would not be difficult to obtain. There are issues about valuation, of course, but certainly for

base pay and for performance pay the information is to hand. There are other options, but we really need a fix on the distribution and the variance to make sense of executive pay. All the texts about efficient markets for executives rings hollow without being put to the test against hard data. For example, figure 5 at page xxii in the introduction, the discussion says this shows us that the share of incentive pay in total remuneration is bigger for bigger companies. But when I look at that bar chart, the line is higgledy-piggledly. It increases, the share going from big to small, the share falls and then it rises and then it falls and stays flat and then it rises again and falls and rises. How do we account for this if there is some monotonic relationship between firm size and performance and how can we make sense of it if we don't know what the variation is around the mean?

So we say the commission should include a recommendation in its final report about improving data adequacy. This issue is not going to go away. This inquiry is being bedevilled by the lack of data with integrity and is remarked upon several times, nearly every page. For the future we should have a better fix on it and we ask that in the final report the commission make some recommendations to that effect.

MR BANKS: Just one quick comment on that, Grant. I take the point you're making but the biggest problem we've faced was the like of time series data because the data since 2000, in 2002 and 2003 is a hell of a lot better and it just gets worse and worse. You would have seen from the chart where we've stitched together a number of different series with different coverage and so on. So to some extent bygones are bygones, it's now impossible to retrace those data series. But I guess the point you're making is from here on forward trying to rectify that and then there's the question of whether the existing data sets now need to be improved.

MR BELCHAMBER (ACTU): We're not calling on you to survey the past, we're talking about where we go from here and our proposal is that the commission make recommendations for the future so that a time series, with statistical integrity will exist in 10 years time or whenever the public and policymakers again want to look at this issue. I do note your use of different data series. 20 years it was the Egan data that was used in the impact reports. That's gone, it was either a box criticising David Peetz's attempts to splice the series. It's a problem with the data. We don't have it and we should have it and you can recommend that it be compiled and put together and it is a low-cost recommendation.

The third point, on my read of it at several places the draft report borders on post-hoc rationalisation in seeking to explain excessive growth in executive remuneration. At box 1 at page xxi much of chapter 4 has this character. The story given is that the mix of executive remuneration has shifted with a greater share of the pie being at risk. This brings with it a risk premium in the salary package demanded. This is directly analogous to the compensation differentials thesis from orthodox

economics which says that fixed term contract workers or casual workers will demand higher pay to compensate them for the absence of leave entitlements and for the absence of job security compared to permanent workers or open-ended contract workers. The evidence is overwhelmingly to the contrary and there is plenty of it here, in Europe and in the US. The Productivity Commission should not be hoodwinked into being the apologist for executive excess.

The real market works as a more or less closed loop between remuneration committees and boards and the remuneration consultants on the application of the principle of restoration of relativities. Consultants have a client list and data that they compile from those clients and make the rounds on a regular basis once a year or thereabouts, not just fixing rates for new appointments but adjusting salaries from time to time and firms seek to maintain their position in the ranking amongst their peers. That's how it works.

We support the proposal that remuneration reports should be in plain English and should have the material in them on total realised pay. That should be reported and we agree that the use of remuneration consultants should be disclosed in those reports too. On tax and the tax treatment of termination packages, tax more generally, it's probably appropriate to leave much of that to the Henry review. We think that the Productivity Commission should not foreclose on the appropriateness of, for example, limiting the tax deductibility of executive remuneration to certain levels. There's a reference to the US and a cap being placed on the deductibility of non-performance remuneration. But for total remuneration packages, it may well be an option that the Henry review considers and we don't think it will be appropriate for this draft report to say whether that's good or bad on the basis of some theoretical review of an efficient market hypothesis for executives.

So that is a few points. It is a large report and a welcome report and we look forward to the release of the final report and some strengthening of the recommendations, particularly concerning the two strikes' proposition and to nailing it down so that it has real and substantive impact and effect.

MR BANKS: Thanks very much for that. Just one comment on the data thing and I was thinking about it as you were talking, one of the problems we face, as you know - and it's reflected in that chart you were talking about - is that the data and remuneration is a construct part of which is an expected value for remuneration in the future and one of the reasons why we suggested that realised pay would be a good idea is that it's often hard to tell from the construct what's going to happen. Sometimes it might understate, sometimes it might overstate the reality. Then I think about how the Bureau of Statistics operates in terms of statistical integrity and so on and I can foresee some problems there that may not arise in relation to other remuneration where it's primarily a fixed salary or a fixed wage that can be factored

in as a single number. I don't know whether you have any thoughts on that.

MR BELCHAMBER (ACTU): The Bureau of Statistics grapples with these issues already. It provides indexes including bonuses and excluding bonuses. It deals with non-cash forms of remuneration in various surveys. For national accounts purposes it uses different measures. The important thing is that the bureau compiles a series on a consistent basis where the concept sources and methods are clearly set out and we know what is included and what's not included. If the bureau were to find that it's too hard to value non-recourse loans, for example, or stock options or some other aspect of a remuneration package, it would define its terms and tell us what it is measuring and then it's there for the analyst to make a case, for example, that the share of remuneration has shifted from what is being measured to what's not being measured or the other way.

But at least we'd have some hard factual basis for establishing a debate, an informed debate about what's going on. At present it seems everyone who looks at it says there's something wrong here with executive salaries, but the discussion says, "Well," on the one hand, on the other, "Maybe, maybe not; the data's too poor; we can't really say; how would we know." You can contribute substantially to informed public debate by making some recommendations on data integrity and time series.

MR FITZGERALD: I just want to go back to your comment about the risk premium that might be associated or you're contesting that theory with greater apportion of the salary being by way of long-term incentives or at-risk payments. I know you've drawn the analogy in relation to casual workers and what have you, but do you not accept at all that if you were to provide a CEO with a million dollars fixed and you convert that into some lesser portion being fixed and some greater portion being at risk, then in fact there is in fact a logic that in fact they would require more because of that risk.

I don't understand your dismissal of it so categorically because the evidence seems to us that there is in fact a risk premium. You can argue the actual premium but you're discounting that there should be any increase in remuneration because of the risk factor.

MR BELCHAMBER (ACTU): No, I think that wrongly characterises what I said. One can make up theories to explain movements or changes or the composition of remuneration packages. One of the theories that was made up to deal with different terms of employment for ordinary workers is that if you forego job security and leave entitlements and accept employment as a casual that you'll be compensated for that loss by receiving a higher rate of pay. That's a theory but the evidence is completely in contravention of it. The nature of the explanation being advanced here is on a par with that. It's saying, "If you give up the certainty of your fixed remuneration, you

know you'll be getting dollar bills into the bank account at a fixed time. If you give that up and part of it is delayed or part of it is based on performance, you'll need more to compensate you. It's a compensating differentials argument. It's not measured, the data is not available, you can't really say but the theory supports much of the argument in here against strong intervention.

The theory doesn't hold up in the rest of the labour market where ordinary working people are concerned so the presumption that it holds up for executives is a rather strong one. The other alternative, and it's one that you resort to at various places through here, is that we can't explain it. We don't know. It's a very difficult thing, particularly for the Productivity Commission to say, "Look, not all markets work." But in this case it seems we've got one that can't be explained by efficient and rational processes, at least fully.

MR BANKS: I think in relation to the effect of incentive pay on total pay, I think the empirics as we see them point to that relationship. What you're saying is that the empirics at the other end, in relation to compensating differentials doesn't support that. Is that what you - - -

MR BELCHAMBER (ACTU): Overwhelmingly. Almost every study that looks at remuneration for fixed-term contract workers or casual workers in the Australian parlance against equivalent permanent workers, open-term contract workers by sex, by occupation, by skill - adjusting for all of the other variables - finds that the differential is the other way. That's the nature of the evidence.

MR BANKS: Could you point us to one or two articles that you think best - - -

MR BELCHAMBER (ACTU): On compensating differentials?

MR BANKS: Yes.

MR BELCHAMBER (ACTU): Sure. There was a workshop in Milan on 26 and 27 June on the top, "Low skill, low pay and low income," perhaps 30 papers presented there, half a dozen of them reported additional results on compensating differentials thesis saying that it just doesn't stack up. The evidence just doesn't support it. But any search through the learned journals would find that.

MR BANKS: I'm just thinking, to draw that analogy in part depends on the analysis of the two labour markets, if I could put it that way on both the demand and supply side and other things that might be going on. Another potential perspective on what you've just said is that the orthodox package of remuneration is in some respects too high and, therefore, when you allow another group to deviate from that, you get a drop in the remuneration to employ them. That's why I would be quite

interested to see what the articles say about that.

MR BELCHAMBER (ACTU): That the market pays too much for full-time workers at large in vast capitalist economies?

MR BANKS: No, what I'm saying is that knowing who is in that second group and how they've come into that market, whether they've come out of the full-time market or whether they've come into the part-time market from outside the workforce or - - -

MR BELCHAMBER (ACTU): These studies control for all those worker characteristics.

MR BANKS: I would be quite keen to see that.

MR BELCHAMBER (ACTU): The commission is not familiar with the theory of compensating differentials and the empirical work that's available?

MR BANKS: Our highly trained staff will be across all the detail of this.

MR BELCHAMBER (ACTU): Yes, I'm sure they will be.

MR BANKS: You can help us, I guess, by pointing out some of the - - -

MR BELCHAMBER (ACTU): If it was an international market, the dispersion by nationality in relativities of executive remuneration to average earnings would be evened out. It would disappear if it was subject, of course, to the value you might put on sunshine or long, cold winters or whatever. But between the OECD nations where an executive on that sort of salary could buy the accommodation of their choosing, how do we account for this differential? Between firms that compete in a global economy, how do we account for this differential in the ratio between executive pay and other pay? How does the efficient markets theory explain that?

MR BANKS: One of the things we've tried to do is document to which that differential exists and also across industries. As you would have seen, for example, the differential has not widened in the mining sector at all over the relevant period and understanding what's going on there is one thing. I suppose another thing, to get back to the other point you're making, is when you make international comparisons, they also vary according to the different sectors and the one that's most globally footloose is probably the finance sector and that's where the differentials internationally are probably least so it, to some extent, supports the point.

MR BELCHAMBER (ACTU): And where the differentials between ordinary workers and executive remuneration are highest.

MR BANKS: Are probably highest, that's right. I think that's right, yes.

MR BELCHAMBER (ACTU): So the nature and tone of those comments probably doesn't come as much surprise, but it is a valuable addition to the body of knowledge.

MR BANKS: Just on the two strikes' issue, as you can imagine and if you read on the Financial Review you would have seen on the front page - - -

MR BELCHAMBER (ACTU): Never read that.

MR BANKS: - - - boards haven't been ecstatic with that proposal and there have been issues about whether it makes sense at all and what thresholds it might make sense et cetera. Some have argued that a 25 per cent trigger point for a spill of a board would be disruptive, that it would provide a kind of opportunity, a cloak for third parties trying to take control of the firm and so on. Do you want to comment on any of those observations?

MR BELCHAMBER (ACTU): I think when the disclosure rules first came in a decade or 15 years ago that executive pay would have to be disclosed within bands. It was welcomed by the business sector with open arms. They said, "What a terrific thing, this is going to make the market work better." Some said that it was going to be the end of competition, it was going to cause all sorts of problems. Some today say that the acceleration in executive pay is because of the disclosure requirements. So the fact that you've made a recommendation that would put some hard requirements on boards in dealing with this issue, the fact that you get a response, "We don't like that," is really no surprise. People already play tactical games out there with boards and numbers and what have you. It's the nature of what goes on.

The 25 per cent threshold is, we think, an appropriate threshold in the first instance and in the second instance. It's not 25 per cent to elect a new board, it's 25 per cent to let shareholders vote and it's a significant minority. The situation at present in many respects stacks the deck in favour of the incumbent board as it is and there's some discussion in your report about some of these issues. We think that institutions are cautious and will be cautious in exercising votes and proxy votes on remuneration reports at AGMs. 25 per cent is a significant view and if it happens twice, it should cause the board to be put to the test.

MR FITZGERALD: Can I just clarify the current position in relation to the taxing of CEOs' salaries. As I understand it you're still maintaining a view that there should be a higher tax payable on salaries over a million dollars, as I understand it. I'm not quite sure what that higher tax rate would be. I just want to clarify, it's the million

dollars, not just base salary, you're talking about in terms of total remuneration.

MR BELCHAMBER (ACTU): Yes.

MR FITZGERALD: The second thing is what do you actually think would happen - in one sense one of the things that has been difficult in this inquiry is that irrespective of the actual quantum, it represents a very small portion of the total expenses of a firm. So you can increase the tax rate to the company, for example, but in one sense it will have almost no effect at all. Yes, it will make the salary more expensive, but they will be easily able to bear that. I'm just wondering what you actually think the effect will be of imposing higher rates of tax on this particular area. All we would is that the companies would in fact compensate the employee more fully for that, it would have very little effect on the bottom line. So why do you think that a higher tax rate would actually have an effect?

MR BELCHAMBER (ACTU): The proposition in ACTU policy is that deductibility as a business expense for that portion of salaries in excess of the threshold, let's say a million dollars, be disallowed. That means boards can pay their chief executives whatever they like, but that portion over the threshold comes out of after-tax profits for the company. So it increases the connection between the interests of shareholders and the value for money they get from the executive - - -

MR FITZGERALD: I understand the technique you're describing but I wonder whether it actually would have any effect any way.

MR BELCHAMBER (ACTU): It would have some effect on consolidated revenue. There would be more money in the Treasury coffers and if secretary of the Treasury thinks it's of no consequence to him whether there's more money or not, I'm sure he'd tell you. The size of the impact can be assessed by any number of yardsticks and using some yardsticks it can appear minuscule and on others it can appear substantial.

MR FITZGERALD: You would acknowledge that your position is different from the shareholder groups. I mean, none of the shareholder groups have actually talked about imposing mandatory caps or in fact higher tax rates. They have taken that view to form a better alignment with shareholder interests and so on. So in one sense there does seem to be a dichotomy between your position and those that the shareholders are putting which is, as I say, trying to get greater alignment. But the problem that I've got with the proposals is I'm not quite sure that even if you implemented these proposals it would actually have any impact at all. The converse is that it may have some perverse outcomes in relation to the ability to attract CEOs and so on and so forth.

But it is curious that none of the shareholder groups are actually putting these recommendations forward so they obviously don't believe that they're beneficial to their interests.

MR BELCHAMBER (ACTU): Those two points that you made are incongruous. They don't sit squarely. Either it has no effect and is inconsequential, in which case it would have no impact on recruitment of executives or else it does have some impact and then the question on recruitment of executives is another matter. What it means is that executives will bargain in after-tax terms or companies will bargain in after-tax terms. How that's going to impede the recruitment of executives is beyond me. The proposition about deductibility of excessive salary components, it's been part of our policy long before this inquiry was - 10, 15 years or more, early 90s or mid-90s was the first time the ACTU proposed this addition to the tax law. It's what the shareholders' association say is a matter for them.

We ask that the proposal be assessed on its merits. This proposal is not putting an absolute cap on executive salaries, it's letting the market work but it's bringing to a finer point where the cost falls. It's not subsidised by the broader community through tax concessions at very high levels. As to whether it's on base or total, maybe there's - - -

MR FITZGERALD: That became a US problem, of course, where it was only bases - - -

MR BELCHAMBER (ACTU): It was on non-performance pay, yes.

MR FITZGERALD: Then suddenly there was merging of performance pay as a way of getting around it. So the question about what it's on is significant but only because in the US example where it was only on base it had almost no effect other than to drive up incentive pays and take all the bases up to the million dollars.

MR BELCHAMBER (ACTU): The other issue is whether it's on cash or non-cash and I think that's an issue that directs attention to other parts of the tax system and how different forms of income are taxed.

MR BECK (EG): Okay. We will think some more about that. The only other question I was going to ask you was that you talked about the closed loop that exists with remuneration consultants and firms and so on.

MR BELCHAMBER (ACTU): It's substantially a closed loop.

MR BANKS: But you also said, however, that you didn't think disclosure had been part of the spiral that's occurred. I think you said that but I'll just get you to comment

on that, whether you think the individual disclosure that has occurred exacerbated the kind of ratchet effect.

MR BELCHAMBER (ACTU): What I said was that some people have argued that it did and I think I laughed at the time - I'm not sure if that was picked up in transcript.

MR BANKS: You have to say "ha ha ha" for it to get picked up.

MR BELCHAMBER (ACTU): Okay. I don't think that's a plausible explanation for any component of the executive salary spiral. They're not significantly different from zero, the disclosure. Everyone is part of disclosure. Disclosure comes at different times in different countries. What's wrong with full information? I thought full information makes markets work better.

MR BANKS: I can't disagree with that.

MR FITZGERALD: Just a side question. In the report we have briefly dealt with the issue of some of the institutional investors, including both retail and industry superannuation funds being required to disclose how they voted on remuneration issues and what have you. Are you generally satisfied with the way in which superannuation funds, for example, are actually using their shareholder power or are there things that you would see as being important? A lot of our report has been to try to increase the ability of shareholders to exercise influence through a number of measures, not only the two strikes' policy. Some people have said, well, in a sense that more activity or more concern should be shown as to some of those very large shareholders groups. So I'm just wondering whether or not there are issues there that we should be looking at or are you generally satisfied with the way in which they operate in terms of their shareholder power?

MR BELCHAMBER (ACTU): I would ask some colleagues at ACTU with a deeper connection with superannuation, if they want to add to this. I think the industry super funds, public sector funds and the large corporate funds are increasingly voting their shares on an informed basis where matters of remuneration, contentious issues are brought to the attention of boards. The decision is taken, informed by some association recommendations, so analysis - AIST does some analysis of issues coming up at AGMs and where remuneration reports come up and decisions are taken consciously to vote the shares. I think it's a situation which has improved greatly and so far as that group of institutional investors go, the voting of shares is taken seriously and decisions are made on informed basis. I don't speak about the retail sector and the master funds because I don't know.

There are related issues about stock lending and who exercises rights. In some

instances stock lending proceeds with the right to vote the shares remaining with the original owner. So in the main it's not an issue that concerns me.

MR FITZGERALD: Okay, good.

MR BANKS: Thanks again very much for appearing.

MR BELCHAMBER (ACTU): See you next time.

MR BANKS: We will adjourn the hearings now and resume in Sydney on 9 November.

AT 4.31 PM THE INQUIRY WAS ADJOURNED UNTIL
MONDAY, 9 NOVEMBER 2009